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By Wright Matthews

If I were permitted absolute freedom to choose the group with which I should prefer to discuss the problems involved in my work, I would unhesitatingly select the American Institute of Accountants. The profession of accountancy for the last twenty years has been an integral part of our taxing system. Our principal sources of revenue have been derived from transactions and activities, for which the forms of record have been prescribed by the accountancy profession. The accuracy of these records has depended upon accountants' proficiency. Although the legal profession, to which I have the privilege to belong, has inevitably been engaged in the work of interpretation and litigation, it has devolved principally upon accountants to blaze the trails in modern tax administration.

In coming here, therefore, I feel I come to a sympathetic and understanding audience. At this particular juncture, those of us engaged in governmental administration are in need of sympathy and understanding. I am grateful for this opportunity to talk about our federal tax problems.

It was only natural at the outset of President Roosevelt's administration that the most conspicuous policies and actions would be those involving not the collection of revenue, but the expenditure of money. Disputatious critics may argue about the form, manner and wisdom of these expenditures. The limits of time as well as the obvious purpose of my talk, restrict me to a discussion of the ways and means of paying the bill.

The decade prior to 1920 marked a fundamental change in our federal taxation policy. It marked the opening up of a new and different source of revenue. The corporation excise tax of 1909 and the income-tax law of 1913 were the forerunners of the ready means whereby the government gathered the unprecedented revenue needful to the prosecution of the war.

The war period was followed by another decade, to which many different appellations have been applied. From the point of view of policy and administration this decade was principally devoted

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to the settlement of important tax disputes arising primarily out of the war period and to lightening of the tax burden. The unprecedented economic activity of the decade which ended with 1930, probably accounts for the failure of the government to be more farsighted in the matter of perfecting its system of taxation. During that decade miscellaneous excise taxes generally were dropped from the system; the revenue from income taxes was ample for the current needs of government.

During the last year the treasury department has conducted an intensive study, including personal investigation of some features of foreign taxing systems. The object of this study has been to recommend to congress a general program designed to produce necessary future government revenues with the least possible disturbance to business. This undertaking has been made especially difficult by the fact that municipalities and states, in their need for revenues, have either preëmpted certain fields and objects of taxation or have pyramided their local imposts on taxes already imposed by the federal government. Under our system of government, it is extremely difficult to coördinate these innumerable local systems of taxation with our federal system.

We have read lately of the tax burden of the American people. It is my observation that the American people are not unduly tax-burdened. We are tax-conscious. This idea, perhaps, sounds strange. Its truthfulness can be demonstrated. In the United States a single person with a net income of $1,000 pays no tax. In England such a person pays an income tax of $33.75. In the United States a married person with a net income of $2,500 pays no tax. In England such a person pays a tax of $182.81. In the United States a single person with a net earned income of $10,000 pays a tax of $560. In England such a person pays $1,701.56, or more than three times the amount paid by a citizen of the United States. In the United States a married person with a net income of $40,000 pays a tax of $5,979. In England such a person pays a tax of $13,242. During the fiscal year 1932 the United States collected $1,056,756,697 in income and profits taxes on net incomes totalling approximately $17,300,000,000. During the same year England collected $2,123,835,520 in income and profits taxes on net incomes totalling approximately $13,-800,000,000.

The specific exemption allowed a single person in England is $500 compared with $1,000 in the United States. The specific exemption allowed a married person in England is $750 compared with $2,500 in the United States. The normal rate of tax in England is 22½% of the net income. However, on the first $875 above the specific exemption the tax is one half of the normal rate or 11.25%, and 20% of earned income not exceeding $1,500 is exempt. Including taxes, both national and local, the per-capita tax burden in England is about 40% greater than the per-capita tax burden in the United States. The per-capita public debt of England, including the debt of the local subdivisions, is approximately two and one half times the per-capita public debt of the United States and the states including their local subdivisions. In fact we could go in debt seventy-two billion dollars more before we arrived at the same per-capita debt as England.

We are confronted today with the need for revenue as great as that which confronted us during the war. It is a strange and unaccountable phenomenon that those able to pay taxes should be willing to give up their last penny to defend the country against an enemy outside our gates and should be contrarily inclined when fighting an enemy even more dangerous within our gates. Unlike the war period, with its rapidly expanding and unprecedented profits, the present period is largely one of vanished or very slim profits. With income diminished, it was inevitable not only that most rates of income taxes be raised but that new objects of taxation must be found. For example, income taxes for 1929 amounted to $2,331,274,428.64, and all other taxes to $607,779,946.79. For the fiscal year 1934 income taxes amounted to $817,025,340, and all other taxes to $1,483,790,969. These figures clearly show the trend which necessity has dictated. The figures do not include processing taxes, which in 1934 amounted to $371,422,885.64.

As technicians, accountants will understand that the duty of administrative officers is primarily to deal with the facts. We can contribute our experience to those who determine questions of policy, but primarily our job is to administer the law as it is given to us with respect to the facts as we ascertain them to be.

Certain provisions of the 1934 act were prompted by a condition which reminds me of the story of the man who was examining applicants for position as coachman. Each candidate was submitted to the same test question. The employer took the candidates to his veranda. Pointing out a precipice, he asked each candidate how closely he could drive a coach and four to the edge of the precipice without falling over. Varying answers were given, of course, each candidate estimating the proximity with which he could approach the precipice without danger to the occupant of the coach. Finally, one candidate answered the question by saying that if it were his good fortune to be selected for the job, it would be his constant purpose to keep the coach and four as far as possible away from the precipice. Needless to say, he got the job.

The experience of the bureau, in regard with what are commonly called "loopholes" in past statutes, has been that taxpayers have been inclined to employ the coachman claiming the greatest skill in driving close to the edge of the precipice. In some of its provisions the 1934 statute was designed to keep taxpayers and their advisors away from the precipice and to serve notice that those who elected to display their skill in driving close to the edge would do so at great risk.

In approaching technical questions, I do so with much trepidation, for two reasons: first, because of my own limitations, and second, because of the comprehensiveness of the subject matter. A discussion of particular changes made by the revenue act of 1934 would be to paraphrase that act.

There is one phase of every revenue act in which all taxpayers and their representatives have a common interest. I refer to the statute of limitations. Failure to protect a client's rights within the time allowed by law is inexcusable.

Statutory periods governing estate, gift and miscellaneous internal revenue taxes have not been modified materially in the 1934 revenue act. The provisions relating to estate and gift taxes continue as before, that is, generally speaking, there is a period of three years from the date when the return was filed, within which the commissioner may assess the tax (section 310, revenue act of 1926; section 517, revenue act of 1932), and the same length of time, that is, three years, running from the date the tax was paid, within which a refund or credit may be allowed to the taxpayer or a timely claim filed by the taxpayer (section 319 (b), revenue act of 1926, as amended by section 810 (a), revenue act of 1932; section 528 (b), revenue act of 1932). A corresponding period of four years applies in the same manner to the assessment and to the refunding or crediting of all miscellaneous taxes. Section 1109, revenue act of 1926, as amended by section 619 (a), revenue act of 1928; section 3228, *Revised Statutes*, as amended by section 1106, revenue act of 1932.

Important changes have been made in the revenue act of 1934 in the periods of limitation applying to income taxes.

First, the general period within which assessment may be made or a court proceeding be begun without assessment, running from the date of the filing of the income-tax return, has been extended to three years as compared with the two-year period provided in the revenue acts of 1928 and 1932. (Section 275 (a).) This provision (as in the case of all other provisions of title I of the act relating to income tax) applies to taxable years beginning after December 31, 1933. A change has also been made in the time within which a "prompt assessment" must be made, where a request for such an assessment is filed by a representative of a deceased taxpayer or a corporation about to be dissolved. (Section 275 (b).) The period in this instance is now eighteen months instead of twelve months. Of course, the running of the three-year period is suspended whenever a statutory deficiency notice is mailed before its expiration (section 277), and it may be extended by a proper waiver. (Section 276.) The new act also specifies that the three-year period does not begin to run before the last day on which the return was due, even though the return was filed before that day. (Section 275 (d).)

The second important change having to do with statutory limitations appears in section 275 (c) of the revenue act of 1934, and is of a kind new to our income-tax laws. This section provides that, if a taxpayer omits from gross income an amount which should have been included, which is in excess of 25% of the gross income reported, assessment of the tax may be made at any time within five years after the return was filed. This new provision should encourage a voluntary disclosure by the taxpayer in his return of all facts relating to important transactions, the taxable status of which may seem doubtful to the taxpayer.

A third change of importance is the lengthening of the time for making allowances of refunds and credits and for the filing of claims for such allowances. The period for making refunds and credits has been changed to three years from the time the return was filed, or two years from the time the tax was paid, whichever period expires the later, unless a claim is filed within one of those periods. (Section 322 (b).) This section also contains a new provision to the effect that, where overpayments are found by the board of tax appeals, no refund or credit can be made unless the board finds in its decision that the tax was paid within three years from the filing of the claim, or of the petition, whichever is earlier. (Section 322 (d).) It should be pointed out that prior acts have also been amended to enlarge the jurisdiction of the board to cover the statutory status of overpayments, section 504. These provisions make it unnecessary for a taxpayer to resort to the courts because the commissioner holds that an overpayment determined by the board is not refundable.

In addition to these changes, which apply principally to income taxes imposed by the revenue act of 1934, changes have been made in the periods of time applicable to the filing of petitions with the board of tax appeals and the commencement of proceedings in the courts. The most important change of this type is the lengthening of the period for filing a petition with the board from sixty days to ninety days after the date of the registered letter, which is sent by the commissioner as a notice of his final determination. (Sections 272 (a) and 501.)

With respect to suits brought by the commissioner for erroneous refunds, section 502 of the new act amends section 610 of the 1928 act to permit such a suit within five years in cases where the refund was induced by fraud or misrepresentation, but this provision does not apply where the two-year period expired before the enactment of the 1934 act.

Probably no changes brought about by the new revenue act have provoked more discussion among tax accountants and tax attorneys than those changes relating to capital gains and losses. Tax services and tax magazines during the past few months have commented freely on this subject. It does not appear either necessary or advisable that I should try to answer at this time any of the questions which have been and are now being raised about these new provisions.

Section 117 of the 1934 act provides an entirely new method for treating capital gains and capital losses. There is no longer any special tax rate applicable to these transactions as in prior law beginning with the 1921 act. The system of limiting losses upon the sale of stocks and bonds, as provided in the 1932 act, has also been superseded.

Under the 1934 act, in the case of a taxpayer other than a corporation, the gain or loss upon a sale or an exchange of property is recognized upon a graduated percentage basis, depending upon the length of time the asset was held by the taxpayer. The percentage of gain or loss recognized varies from a minimum of 30%, if the property has been held more than ten years, up to 100%, if held for not more than one year. (Section 117 (a).) The rules for determining the period for which a capital asset has been held are similar to the corresponding provisions in the revenue act of 1932.

Capital assets are defined in section 117 (b) of the new act and, broadly speaking, they may be said to include all property held by the taxpayer, except property of a kind which should be inventoried at the close of the year or property held for sale to customers in the ordinary course of the taxpayer's business.

Section 117 (d) limits the allowance of losses from sales or exchanges of capital assets to the sum of $2,000 plus the gains from such sales or exchanges. This is an important limitation, which affects all taxpayers, including corporations, except that, under certain conditions, capital losses from sales of bonds, notes and like securities suffered by banks and trust companies doing a deposit business are not so limited. There is also an important limitation upon losses contained in section 24 (a) (6) of the new act, which provides that no deduction shall be allowed for losses from sales or exchanges of property between members of a family or between a person and a corporation controlled by him, except in the case of distributions in liquidation.

Gains or losses from "short sales" of property are considered as gains or losses from sales or exchanges of capital assets. (Section 117 (e).) Amounts received from the retirement of corporate bonds are considered as amounts received in exchange for the bonds. (Section 117 (f).)

Dr. Thomas S. Adams is quoted as having said that the only complication in taxing statutes is the rate. The income-tax title of the revenue act of 1934 is applicable to taxable years beginning after December 31, 1933. There is imposed a normal tax of 4% on the amount of the net income in excess of the exemption and credits instead of the 4% and 8% normal tax provided by the revenue act of 1932. The surtax is imposed at graduated rates upon the "surtax net income" and ranges from 4% on surtax net income in excess of $4,000 and not in excess of $6,000 to 59% on surtax net income in excess of $1,000,000. The "surtax net income" is the amount of the net income in excess of the personal exemption and credit for dependents.

The privilege of making consolidated returns has been limited in section 141 to affiliated groups of corporations, each of which is either (a) a corporation whose principal business is that of a common carrier by railroad or (b) a corporation, the assets of which consist principally of stock in such corporations, which does not itself operate a business other than that of a common carrier by railroad. An additional tax of 2% is imposed under section 141 (c) for the privilege of making such consolidated returns.

The commissioner is still authorized to allocate gross income or deductions in the case of two or more organizations if this be necessary to prevent evasion of taxes or clearly to reflect the income of such organizations. (Section 45.) The new act extends the application of this section to every form of organization whether or not engaged in a trade or business.

A subsection relating to the publicity of certain information in the returns is a new feature in the revenue act of 1934. (Section 55 (b).)

Another new section provides for a surtax on "personal holding companies." The tax is at the rate of 30% upon the amount of the "undistributed adjusted net income" not in excess of $100,000 and at the rate of 40% upon the amount of the "undistributed adjusted net income" in excess of $100,000. (Section 351.)

The definition of the term "reorganization" has been changed in section 112 (g) of the act, so as more clearly to define the term. In the revenue act of 1932 (section 112 (i) (l)=(A)), the term "reorganization" was defined as "a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation)." The corresponding provisions of the new act in section 112 (g) define the term "reorganization" as "(A) a statutory merger or consolidation, or (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation." The remaining provisions relating to the definition of a reorganization are the same as those of the revenue act of 1932.

Another change in the law governing recognition of gain or loss in reorganizations is the omission in the new act of the provisions corresponding to section 112 (g) of the 1932 act. This section of the 1932 act provided that, if there was a distribution to a shareholder in a corporation, a party to the reorganization, of stock or securities of that corporation or of another corporation, a party to the reorganization, without the surrender by the shareholder of any of his stock or security holdings, no gain was recognized upon the receipt of such stock or securities. Under the new law, a gain is recognized to the distributee in such a transaction.

Several important changes have been made in section 113, which governs the determination of the adjusted basis for gain or loss upon the sale or other disposition of property.

In the case of property acquired prior to March 1, 1913, the rule is that, if the adjusted cost is less than the fair market value at March 1, 1913, the basis for determining gain shall be such fair market value, and this was the rule in prior acts. However, the basis for determining a loss is limited by the new act to the adjusted cost, even though the March 1, 1913, value is greater than such cost. (Section 113 (a) (14).)

Another important change relates to partnership property; such property acquired after February 28, 1913, now is on the same basis as it would have been in the hands of the one who transferred it to the partnership, adjusted for any gain or loss recognized at the time of the transfer.

With respect to gifts made after December 31, 1920, the loss to the donee upon the disposition of the gift is limited under the 1934 act to the basis of the property in the hands of the donor (or last preceding owner by whom it was acquired by gift) or to the fair market value of the property at the time of the gift, whichever is lower. (Section 113 (a) (2).)

The law relating to property transmitted at death has been somewhat simplified. Section 113 (a) (5) of the revenue act of 1934 conforms to the language of the revenue act of 1926 and provides in effect that the basis for property valuation, whether real or personal, and whether acquired by bequest, devise or inheritance, or by the decedent's estate from the decedent, shall be the fair market value at date of decedent's death.

The basis for depreciation and depletion under the provisions of section 114 is determined in the same manner as the basis for determining gain. Percentage depletion allowances are unchanged in the new act. In the case of coal, metal and sulphur mines, taxpayers are allowed a new election when filing the first return under the 1934 act, as to whether or not depletion shall be computed on a percentage basis. (Section 114 (b) (4).)

As already pointed out, miscellaneous taxes have far outstripped income taxes. Under the head of miscellaneous taxes we have estate tax, gift tax, capital-stock tax and various excise taxes.

The most important recent change in the estate tax is the imposition by the revenue act of 1932 of an additional tax which greatly increases the federal revenue from this type of taxation. The revenue act of 1926 is still in force and is, in fact, the basic estate-tax law, as the provisions relating to the make-up of the gross and net estates and the necessary administrative provisions are contained in that act. The result is that we are now administering two estate taxes—the tax imposed by the revenue act of 1926 and the additional tax imposed by the revenue act of 1932. Furthermore, an individual estate may now be liable for both taxes.

The method of computing the additional estate tax has not been changed by the revenue act of 1934. However, the maximum rate of 45% under the revenue act of 1932 has been increased to 60% under the revenue act of 1934, as compared with 20% under the revenue act of 1926. (Section 405.) This provision applies only to transfers of estates of decedents dying after May 10, 1934. Estates of non-resident citizens have been placed in the same category with estates of residents, both with respect to the specific exemptions and the inclusion of property in the gross estate. (Section 403.) Real property situated outside of the United States is specifically excluded from the gross estate. (Section 404.)

The gift tax is new, in that no such tax existed at the date of the enactment of the revenue act of 1932, but this tax has an historical precedent in the provisions of the revenue act of 1924. The revenue act of 1934 amends the gift-tax act of 1932 by increasing the rates to a maximum of 45%. (Section 520 (a).) This is an increase that corresponds with the increase made in the estate-tax rates, so that the new gift-tax rates will equal three-fourths of the new estate-tax rates. The new gift-tax rates do not become effective until the calendar year 1935.

A capital-stock tax, effective beginning with the taxable year ended June 30, 1934, is imposed upon corporations with respect to carrying on or doing business. (Section 701.) It constitutes substantially a reënactment of the capital-stock tax imposed by section 215 of the national industrial recovery act. Exemptions from the tax are provided in section 701 (b) of the act. The tax is measured by the adjusted declared value of the capital stock, instead of the fair average value of the capital stock, and is also payable at the end of the taxable year instead of being payable in advance. As a corollary to the tax to insure the declaration of a reasonable value, congress has imposed an excess-profits tax of 5% on the income in excess of 12½% of the adjusted declared value of the capital stock.

The revenue act of 1934 eliminates the tax on certain miscellaneous articles, changes the rates on others, adds new articles to the list of those already taxed and provides additional administrative measures for the protection of the revenue.

Perhaps treasury decision 4422, which has been given considerable publicity during the past few months, has been the cause of concern to accountants. This treasury decision was promulgated February 28, 1934, and was the direct result of a report of the subcommittee of the house ways and means committee dated December 3, 1933, which, in its consideration of revenue legislation, recommended a flat reduction of 25% in the depreciation deductions of all taxpayers which would have been allowable for the years 1934, 1935 and 1936. The treasury department opposed the flat reduction recommended and in a letter dated January 26, 1934, to the chairman of the committee on ways and means, Secretary Morgenthau urged that it would be more equitable to remedy this situation through proper administrative measures rather than through legislation which would arbitrarily reduce every taxpayer's depreciation allowance by a certain percentage whether or not the allowance may have been excessive for past years. Congress recognizing the fairness of the department's attitude and relying on assurances of proper administration made no statutory changes with respect to depreciation deductions, and as a consequence treasury decision 4422 was promulgated.

Subsequently the bureau of internal revenue issued IT:A&C mimeograph Coll. No. 4170, R. A. No. 714, which outlines in detail the procedure to be followed in carrying out the provisions of the treasury decision. It is highly important that everyone interested in the question of depreciation as it relates to income-tax returns study carefully those instructions, for it is believed that practically all questions that arise with respect to this problem are answered in the mimeograph.

Of primary importance are the instructions with respect to what taxpayers are required to file depreciation schedules and for information I should like to read that portion of the mimeograph:

"In cases where the required information has not been furnished, the revenue agent or other examining officer should advise the taxpayer with respect to the schedule and supporting information which must be prepared. If upon the review of the return of any taxpayer it is apparent that the deduction claimed for depreciation is a very minor factor in determining net income, or that the facts indicate conclusively that the deduction claimed in the return is not in excess of the correct amount, or where it is clearly evident that no taxable income will be developed, the schedules need not be furnished for such year. In all other cases the information required by treasury decision 4422 and by this mimeograph must be furnished and after verification by the examining officer should be made a part of his report."

It is evident, therefore, that taxpayers are not required to file the information called for in treasury decision 4422, unless specifically requested to do so by agents of the bureau, for the returns of many taxpayers will come within the exceptions just mentioned. Before leaving this question I want to give assurance that the bureau desires to administer the provisions of treasury decision 4422 with the least possible burden to taxpayers, and only in those cases where it is evident that the amounts claimed for depreciation have been in excess of reasonable amounts will the information called for by treasury decision 4422 be required. Obviously those taxpayers whose depreciation deductions are clearly excessive and unreasonable will be compelled to reduce their claims for depreciation, with a consequent increase in the income tax to be paid for the years now open. Those taxpayers whose depreciation deductions have been reasonable have absolutely nothing to fear.

One particular phase of the administration of the revenue laws, which it is believed is quite generally misunderstood, is the subject of offers in compromise. Accountants can render us great assistance through clear explanations to their clients of the various features of this problem.

The popular conception of a so-called "compromise case" appears to be that it is something which any bureau officer can do with as he pleases—the result depending more on the quality of such officer's breakfast than on any other element. This may sound like a wild exaggeration, but some such idea is more or less prevalent.

It is clearly the duty of administrative officers to collect taxes properly due. In some cases this can not be done—but the duty remains and, where the tax liability is fixed, extends to the maximum amount recoverable in the particular case.

The law provides that a federal tax lien is a prior claim over general creditors and this is an important point which is quite often misunderstood or overlooked. The law further provides that tax liability is not discharged by bankruptcy. Many taxpayers appear to feel that the government should stand aside and wait for them to pay other creditors first. Regardless of what may be said on this subject, it is obvious that administrative officers can not suspend priorities definitely fixed by statute. Only the legislative branch of our government can do this.

Many taxpayers, in discussing compromise, appear to feel that the bureau of internal revenue is responsible for all of their troubles. Unquestionably, most taxpayers who have found it necessary to file offers in compromise are in plenty of trouble, but it is the purpose of the bureau to aid by every possible legal means in the alleviation of this trouble.

Congress specifies items comprising the basis for taxation and the tax rates applicable to them. Obviously, then, if the tax in question be income tax, it must be that the taxpayer received the income as made taxable by congress; the same rates of taxation were applied as in the case of other taxpayers; and he would be just as able to pay the resulting tax as any other taxpayer, if it had not been for the fact that he has encountered some subsequent economic disaster. Many cases of this kind arise in taxable exchanges of stock, the market values of which have since severely depreciated. The revenue laws and the bureau of internal revenue have suffered much undeserved criticism in such cases. The briefest analysis clearly shows the situation to be due entirely to market conditions, and if market values had remained constant, the tax would have been no more than an unpleasant incident. This comparison is not confined to cases of the above class, but can properly be made in all compromise cases. In all these cases, the predicament in which the taxpayer now finds himself is directly traceable to some unfortunate circumstance occurring subsequent to the taxable period, and frequently entirely dissociated from the facts giving rise to the tax.

It may seem that this analysis of the situation has not softened the final answer, but it is my belief that a clear understanding of these facts goes a long way toward removing any trace of bitterness from the consideration of these cases.

The older employees of the field service tell of the surprising laxity of accounting and bookkeeping records as late as the outbreak of the world war. It is generally recognized that the administration of the federal revenue acts has been very largely responsible for converting business men to understand the necessity for keeping accurate records which will enable one to determine whether or not an enterprise is actually making money. In a very similar way, I believe that the compromise policy of the treasury department will and should emphasize among business men the advisability of adjusting their federal tax liabilities promptly when they have the profits which form the basis of the tax; to exercise greater care in the preparation of returns, thereby eliminating the possibility of a deficiency liability; and also to set aside in adequate form (preferably in cash or liquid assets) an amount with which to pay accrued taxes and reasonable estimates of taxes.

Besides the new responsibilities incident to the repeal of prohibition, the bureau of internal revenue has had to undertake many additional and novel jobs of administration. Some of these are not primarily problems of tax administration. They fall in the category of the police power. The tax upon "hot" oil, firearms, and upon excessive cotton production are illustrative. We have also a novel experiment in government in the processing tax. The addition of these and other laws to the subjects administered by the bureau of internal revenue has vastly increased the burdens of the secretary of the treasury and the commissioner of internal revenue.